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STATE SOCIETY ACTIVITIES

Calendar of Events

September 7-8—Eleventh Annual Regional Chapter Conference. Location: The Sagamore Hotel, Bolton Landing, Lake George, New York.

October 9—Regular Meeting of the Society. Location: Waldorf-Astoria Hotel, New York.

October 16-19—Annual Meeting of American Institute of Accountants. Location: Hotel Jefferson, St. Louis, Mo.

It is the Patriotic Duty

of Every American Citizen to:

BUY United States War Bonds and Stamps

GIVE to the Red Cross

PROFESSIONAL COMMENT

Digest of War Production Board

CONSUMERS GOODS INVENTORY LIMITATION ORDER L-219
(as amended July 10, 1943)

Purpose

The purpose of this order is to make available adequate supplies of scarce merchandise to wholesalers and retailers when and where they are most needed without disturbing the all-out war effort.

Effective Dates

March 1, 1943—
For businesses whose fiscal year ended November 30, 1942.

April 1, 1943—
For businesses whose fiscal year ended December 31, 1942.

May 1, 1943—
For businesses with any other fiscal years.

Who are Subject to the Order

(1) Merchants and others who are engaged in retailing, wholesaling, jobbing and marketing of *consumers goods, and*

(2) Others who maintain a *mercantile inventory, and*

(3) Whose *inventory* of consumers goods is over $50,000 at the beginning of any quarter of their taxable year commencing after November 30, 1942, *or*

(4) Whose *net sales* of consumers goods were over $200,000 during the twelve months preceding the beginning of any quarter of their income tax year.

For the purpose of this order, businesses under common ownership or control must consolidate the figures and records of all of their units, regardless of corporate distinctions. There is a limited exception to this rule which is not generally applicable.

A manufacturer who maintains consumers goods inventories in stock-carrying branches, or in premises not in the immediate vicinity of the manufacturing plant, becomes subject to this order to the extent of such merchandise.

Consumers goods represents merchandise which individuals buy in present form for personal or household use (typical lines of consumers goods are shown in List A attached hereto), except the following classes of merchandise:

- Foods or beverages for human or animal consumption
- Fuel oil, gasoline, motor oil, grease or allied petroleum products
- Goods sold for consumption on vendor's premises, such as food at fountains and restaurants
- Goods used in rendering personal services, such as shoe repairing
- Producers goods, such as farm implements
- Certain other goods, which are listed in List A of the Order
- Tobacco products
- Footwear

Mercantile inventory represents the stock of consumers goods held for sale by a person engaged in marketing such goods. It includes goods purchased or manufactured, or held for resale under consignment or memorandum arrangements. It may include will-calls or lay-aways, dependent upon the accounting or income tax practice of the merchant. Non-consumers goods may be included with consumers goods if it is the merchant's practice to include them consistently, and if exclusion would be impracticable. Inventories

at the end of a fiscal income tax period must be valued in accordance with the tax returns and the books of account. Inventories during interim quarters may be based on either physical takings, perpetual inventory records or computations on the basis of gross profit percentage indicated in previous year's tax returns.

Net sales represent gross sales of consumers goods, less returns, allowances, rebates, discounts and other proper deductions. Transactions among units of a single organization are not regarded as sales.

Reports to be Filed

A business subject to the Order files reports with the War Production Board *only when and as* its quarterly inventories *subsequent to its first quarter in 1943* exceed its *inventory limit*. Thus (using the second quarter 1944 as an example) if a business has a fiscal year which ended December 31, 1943, its second quarter in 1944 began on April 1, 1944. If on April 1, 1944 its mercantile inventory (of consumers goods) *exceeded* its inventory limit, the following reports must be filed:

*Form WPB—1620—
On April 25, 1944
Form WPB—1621—
On April 25, 1944
Form WPB—1962—
On May 25, 1944
Form WPB—1962—
On June 25, 1944

All items in connection with the Order and the related report forms are to be stated in *dollars*. We are not concerned here with units.

If on July 1, 1944 a business's mercantile inventory again exceeds its then inventory limit, the filing cycle continues (except that Form WPB-1620 is not filed again). If the inventory at July 1, 1944 is under its inventory limit no filing is necessary for the ensuing quarter.

The determination by merchants subject to the Order of the "inventory limit" at April 1, 1944 will be described in the comments that follow. For the sake of simplicity, it is assumed that the fiscal year ended December 31, 1943.

Procedures to be Followed by Controlled Merchants

The "controlled merchant" (that is, one who is subject to the Order) must determine whether his inventory as of the beginning of his quarterly period is greater or less than his inventory limit. This determination must be made prior to the 25th of the first month in the quarter, since returns are due on that date. Thus, if the quarter begins April 1, 1944, determination must be made by April 25, 1944.

The following calculations are necessary in order to determine whether the April 1, 1944 inventory exceeds the inventory limit:

(1) Calculate the *normal quarterly Inventory-Sales Ratio*

(2) Calculate the *Normal Inventory*

(3) Calculate the *Inventory Limit*

Each of these calculations is described below.

Inventory—Sales Ratio

The War Production Board has issued Form WPB-1622 to be used as a work sheet in computing the quarterly inventories of consumers goods from 1939 through 1944 (the years 1939, 1940 and 1941 are considered the base period). This form (which need not be filed) computes the inventories on the basis of gross profit percentages. If quarterly inventories can be determined in any other way, the latter basis can be used. Net quarterly sales during these years are also determined.

* This form is filed only once. It need not be filed again.

Now, using Form WPB-1620, the inventories at April 1, 1939, 1940 and 1941 are then totaled. The sales for the second quarter of 1939, 1940 and 1941 are also totaled. The ratio that the total of the three years April 1 inventories bears to the total of the three years second quarter sales represents the normal inventory-sales ratio for the second quarter of 1944.

Calculation of Normal Inventory

Four steps are involved here (using Form WPB-1621):

(1) Calculation of sales trend ratio.

(2) Calculation of sales projection ratio.

(3) Calculation of projected sales.

(4) Calculation of normal inventory.

Each of these steps are explained in the following comments:

(1) The *sales trend ratio* for the second quarter of 1944 is arrived at by dividing the net sales of the 1943 fourth quarter by the net sales of the 1942 fourth quarter. (The "trend" quarters are always the second preceding quarters; thus for the third quarter 1944 the "trend" quarters are the first quarters of 1944 and 1943.)

(2) If the sales trend ratio is between .900 and 1.100, that will also be the *sales projection ratio*. If the sales trend ratio is less than .900, add one-half of the difference to arrive at the sales projection ratio. If the sales trend ratio is over 1.100, subtract one-half of the different to arrive at the sales projection ratio.

(3) The *projected sales* for the second quarter 1944 are arrived at by multiplying the sales for the second quarter 1943 by the sales projection ratio.

(4) The *normal inventory* as of April 1, 1944 is then calculated by multiplying the projected sales for the second quarter 1944 (as arrived at in Step (3)) by the normal inventory-sales ratio for the second quarter 1944 (as previously described under "Inventory-Sales Ratio.")

Calculation of Inventory Limit

This computation is also made on Form WPB-1621. The inventory limit represents the normal inventory as of April 1, 1944, previously arrived at, *plus* a percentage of tolerance. The tolerance factor represents a percentage of the normal inventory and varies with different locations as follows:

Location	Percentage of tolerance — Cost Method	Percentage of tolerance — Retail Inventory Method
Eastern and Central time zones......	10%	8%
Mountain and Pacific time zones.....	15%	13%

Form WPB-1621 (as well as Form WPB-1620) is filed only if the April 1, 1944 actual or estimated inventory exceeds the *inventory limit*. It need not be filed if the April 1, 1944 inventory is less than the inventory limit, but the form should be prepared and preserved.

Where the merchant feels that the procedures hereinbefore outlined are not fair to his particular business, he may apply for permission to use an increased normal inventory figure or increased tolerance percentages.

Procedures When Inventories Exceed the Inventory Limit

If the April 1, 1944 actual or estimated inventory exceeds the inventory limit, the merchant must then calculate on Form WPB-1621 the

normal receipts and *allowable receipts* during the second quarter 1944.

Normal receipts represent the greater of:

(a) One-third of the cost of sales for the preceding quarter (in this case, the first quarter 1944)

or

(b) An amount computed as follows:

Cost of projected sales during the quarter* plus

Normal inventory at July 1, 1944 less

Actual inventory at April 1, 1944 equals

Normal receipts during the quarter.

The next step is the computation of the *allowable receipts,* to which the merchant is limited so far as his purchases for the second quarter 1944 are concerned. Calculation is made of the percentage by which the actual inventory at April 1, 1944 exceeds the normal inventory (without considering the tolerance factor) at April 1, 1944. The allowable receipts will then be arrived at as follows:

If the above percentage is between	The allowable receipts are
0 and 25%	Normal receipts
26% and 50%	75% of normal receipts
51% and 100%	50% of normal receipts
Over 100%	40% of normal receipts

Forms WPB-1620 and WPB-1621 are then due for filing by April 25, 1944. Thereafter Form WPB-1962 is filed on May 25, 1944 and June 25, 1944. The latter form deals mainly with the control of merchandise receipts during the quarter effected.

Retail Inventory Method

Retailers using the retail inventory method of accounting may reduce their inventories to cost by the method prescribed for Federal income tax purposes, or they may elect to use retail sales valuations throughout. In the latter case, projected markdowns are added to projected sales in computing allowable receipts. The percentage of tolerance differs under this method, as noted in a previous tabulation.

Miscellaneous Provisions

The Order provides that certain sales, inventory and cost records must be preserved for a number of years. Fine and imprisonment penalties are provided for violations of the Order. In complying with the provisions of the order, the merchant must use the same system of accounting consistently employed since the beginning of the base period. If significant changes have been made since that period, application must be made to the Director General of Operations for specific instructions.

Attached hereto is List A, representing lines of goods which qualify merchants for exemption if more than 50% of their sales are in such goods. Also attached hereto, is List B covering examples of typical consumer goods.

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* Cost of projected sales represents projected sales for the second quarter 1944 multiplied by the cost of goods sold ratio for the same quarter in 1943.

List A

Lines of Goods (Whether or Not Consumers' Goods) Qualifying Merchants for Exemption

Antiques
Coal, fuel oil, gasoline, and miscellaneous heat or power fuel
Coffins, burial caskets, and burial vaults
Farm machinery and equipment, and attachments and repair parts therefor
Flowers and plants, except artificial types
Foods and confections
Grain
Ice
Hay
Jewelry having a selling price of $200 or more per piece
Lumber and building materials, except hardware
Motor oil and grease
Motor vehicles and motor vehicle replacement parts
Nonalcoholic beverages
Rubber tires
Second-hand goods
Stock food
Seeds for farm use
Tobacco products (such as cigars, cigarettes, chewing and smoking tobacco)
Typewriters
"Consumers' goods" imported into the United States
Supplies, as defined in paragraph 1046.1 "Suppliers' Inventory Limitation Order L-63", concerning which the merchant is required to keep and actually keeps records on Form WPB-825.

Also exempt are:
Merchants engaged in foreign trade
Merchants 90% of whose sales during the last inventory year consisted of footwear.

List B

Examples of Typical Consumers' Goods

Women's, misses' wearing apparel
Women's, misses' accessories
Baby goods
Men's and boys' clothing
Men's and boys' furnishings
Work clothing
Footwear
Hosiery, underwear, negligees, and robes
Gloves, handbags, and millinery
Aprons, house dresses, and uniforms
Furs
Corsets and brassieres
Lace, trimming, and ribbons
Notions
Toilet articles and toiletries (such as cosmetics, shaving equipment, and soaps)
Clocks and watches
Jewelry and silverware
Umbrellas
Art, needlework, and yarns for home use
Paper and paper products, stationery, books
Giftwares
Piece goods (silks, velvets, rayons and synthetics, woolens, cottons, linens, mixtures, wash goods, and linings)
Drugs and drug sundries
Sporting goods and cameras
Toys and games
Luggage and other leather goods
Garden supplies and seeds for garden use
Motor vehicles, replacement parts, and accessories
Tires
Typewriters
Linens, including towels
Domestics (muslins, sheetings, etc.)
Blankets, comforters, and spreads
Furniture, bedding, and domestic floor coverings
Draperies, curtains, and upholstery
Lanterns, lamps, and shades
Chinaware and glassware
Major household appliances, including mechanical refrigerators, washing machines, and cooking appliances
Small electrical appliances, light bulbs, fixtures, and dry cells
Radios, phonographs, records and supplies
Hardware and tools for home use
Kitchenware, cutlery, and miscellaneous housewares
Musical instruments, pianos, and sheet music
Window shades, blinds, and wallpaper
Brushes, brooms and mops
Soaps and household cleaning and sanitation materials
Paints, varnishes, waxes, and polishes
Christmas ornaments and supplies
Wheeled goods
School supplies
Antiques
Coal
Flowers and plants
Smoking equipment
Second-hand consumers' goods

RECENT PUBLICATIONS

NEW YORK LAWS AFFECTING BUSINESS CORPORATIONS (Annotated)

United States Corporation Co., 1944
627 pages, $2.00.

This is the twenty-fifth edition of this work, revised to March 18, 1944, and includes changes in pertinent sections of the Tax Law, emanating from the 1944 session of the New York State Legislature. Besides the statutes, it includes liberal annotations of judicial decisions in the form of abstracts, in the court's exact language, with numerous citations of supporting cases.

CURBING INFLATION THROUGH TAXATION

By Marriner S. Eccles, Alvin H. Hansen and other distinguished tax authorities

New York: Tax Institute, Inc., 1944
272 pp. Bibliography and index, $2.50.

Inflation is still the number one fiscal problem. It is a threat during the war and will probably be even more of a threat in the postwar period. In these papers which were presented at a recent Tax Institute symposium the speakers come to grips with the inflationary problem in a realistic way.

The First group of papers is concerned with the earmarks of inflation that are now evident in our economy. Milton Gilbert of the Bureau of Foreign and Domestic Commerce discusses consumer spending. Seth D. Sims, Assistant to the Secretary of Agriculture, discusses the boom that is taking place in farm land while Homer Hoyt of the Regional Plan Association of New York speaks on inflation in urban land. The increase in bank deposits and money in circulation is described by Irving Bussing of the Savings Bank Trust Company, New York.

The chapters on inflationary potentialities of the public debt by Alvin H. Hansen of Harvard University and James F. Hughes of Smith, Barney & Company, constitute a particularly important part of the volume.

The sales tax, income tax, spendings tax, forced savings, and other fiscal devices to curb inflation are discussed in chapters contributed by Marius Farioletti, Treasury Department, Godfrey N. Nelson, of the New York Times, Alfred G. Buehler, University of Pennsylvania, Roy Blough, Director of Tax Research, Treasury Department, Carl Shoup, Columbia University, and Seymour E. Harris, Harvard University.

Part Four of the volume is devoted to the experience of other countries in curbing inflation through fiscal devices. Arthur Z. Arnold of New York University, discusses the control of inflation in the Soviet, and George A. Tesoro of the American University, reports on Italy's experience. A. Kenneth Eaton of the Canadian Department of Finance and Mary E. Murphy of Hunter College, speak on Canadian and British experience respectively.

In the concluding section of the book Marriner S. Eccles, Chairman, Board of Governors of the Federal Reserve System, and J. W. Oliver, Secretary, Linen Thread Company, Inc., consider the possibilities of postwar inflation and outline suggestions for tax action to curb it.

"The war on inflation has yet to be won. The most critical battles

will probably come after the war on the Axis is over," declares Professor Mabel Newcomer, in an introduction to the volume. "We hope that the exchange of information and opinions in this symposium may take us one step farther toward our goal."

Renegotiation Regulations

The War Contracts Price Adjustment Board issued on June 7th Chapters III, IV, V, and VI of the renegotiation regulations controlling renegotiation of contracts and subcontracts under section 403 of the Sixth Supplemental National Defense Appropriation Act of 1942, as amended. These four chapters relate, respectively, to determination of renegotiable business and costs; determination and elimination of excessive profits; agreements and statements; and impasse procedure. Simultaneously, revisions were announced in regulations issued by the Board on April 19th. It is understood that the regulations will be published in a manual available from the Superintendent of Public Documents.

Standard Termination Article for Subcontracts

A standard termination article applicable to fixed-price orders or subcontracts for the manufacture of supplies was adopted by the Joint Contract Termination Board early in June. The Director of War Mobilization has issued a directive authorizing the various procurement agencies to recommend the use of this article by prime contractors and subcontractors. Simultaneously he authorized the use by the procurement agencies of a statement of policy, previously adopted by the Board, applicable to the settlement of claims under such terminated contracts. The standard subcontract article states briefly the same general principles as the uniform termination article for prime contracts, issued January 8, 1944, and bases the terms of settlement on "recognized commercial accounting practice," which, according to the statement of policy, are represented in the statement of cost principles also issued on January 8th.

Accountants and the National Roster

Members of the accounting profession who have not previously registered with the National Roster of Scientific and Specialized Personnel are asked to do so immediately. This agency of the federal government is responsible for effective utilization of the nation's professional and scientific talent. Since 1940, it has maintained a central register of persons possessing qualifications essential to the success of the war effort, including those engaged in war industry or serving in any capacity with the armed forces.

It is important, from the viewpoint of national welfare, that professional accountants entering the armed forces notify the National Roster as promptly as possible concerning the branch to which they are assigned, the date and place of their induction, and their serial number. The Roster, as a civilian agency of government, assumes no responsibility in the assignment of its registrants within the armed forces. At the request of the War and Navy Departments, however, information is furnished concerning the specialized training and qualifications of registrants who have been inducted. This information is considered in determining military assignments.

As the war progresses, it may become necessary to withdraw a num-

ber of professional and scientific men from the armed forces for the purpose of assigning them to important research or production work in civilian war industry. Since the Roster's records are sufficiently detailed to permit intelligent selection of persons possessing professional qualifications in practically every specialized field, it would probably be asked to assist in such assignment. Persons possessing specialized professional qualifications are therefore urged to register now and to advise the Roster concerning any change in their status. Communications should be addressed to the National Roster of Scientific and Specialized Personnel, 1006 U Street, N. W., Washington 25, D. C.

Processing of Claims on Terminated War Contracts

By Lawrence R. Schmidt, C.P.A.

THE principles to be used in preparing claims on terminated contracts have been outlined in various Government releases and have been discussed at length at technical sessions of the various accounting societies for the past year. It is the purpose of this article to discuss the internal procedures of the contractor, necessary to insure efficient processing and collection of cancellation claims. While these procedures will vary with each contractor there are certain fundamentals which should exist to insure the common aim; speedy and accurate settlement.

Every war contractor will undoubtedly face the problem of terminated Government contracts, however, the complexities of this problem increase with the number of contracts cancelled, multiplicity of products and the extent of subcontracting involved. The contractor with only a few cancellations does not have the control problem which confronts the contractor with several hundred or perhaps several thousand cancellations. Likewise, if the contractor manufactures but one product his problem is not as complex as that of the contractor who manufactures numerous products with many interchangeable parts. Most authorities on cancellations agree that the problem of apportioning common item inventories constitutes the contractor's major cancellation problem.

Every settlement proposal filed represents the composite information obtained from many sources. It is obvious, therefore, that a problem of coordination exists. To insure proper coordination it is essential that one person be assigned the responsibility for processing and filing of claims. Since preparation of claims involves many accounting questions the logical selection for supervision of this activity would be an accounting officer. A Termination Department sufficiently large enough to cope with requirements should be put at his disposal and full authority given him to obtain required information promptly in the form designated and also to interpret cancellation policies.

Company policies on cancellation proposals must be definitely established at the outset. Nothing disrupts the orderly processing and collecting of claims more than having management vacillate on the methods and procedures to be followed. Many contractors in their eagerness to file claims failed to give full consideration to the problem confronting them and neglected to systematize this important function, and as a result the benefits of initial speed were in many instances lost by the necessity of revising original proposals and also by failure to fully recover the amounts to which properly entitled.

Two principles which should be required are:

1. Reduce all pertinent facts and data to writing.
2. Retain copies of all information related to a cancellation in one file, preferably in the department responsible for filing the claim.

Where the contractor receives cancellations of orders for repair parts, spare parts or other small orders,

First Prize Paper in 1944 Prize Essay Contest.

the ultimate amount to be claimed may be so insignificant that preparation of a claim is unwarranted. This might likewise be true of the cancellation of a substantial order where only some minor preproduction expense has been incurred.

Instances are known where contractors have spent hundreds of dollars of clerical time to prepare claims for one or two dollars which management naturally absorbed rather than file. If management at the outset had established a minimum amount for which claims should be prepared, the time spent on these small cancellations could have been applied to the processing of more substantial claims.

The other extreme must likewise be cautioned against i.e. settling claims on a "no charge" basis without sufficient investigation of the potentialities of the cancellation. This can be avoided by prescribing the minimum review that must be performed when the value of the sales order cancelled is in excess of a nominal amount and requiring a responsible person to authorize all such write-offs. As an added precaution against injudicious "no charge" cancellation settlements, procedure should provide for an independent review by the contractor's Internal Audit Department of the files on all cancellations so settled.

As an indication of the coordination problem involved in processing claims let us briefly trace the progression of a cancellation from the time received until settlement proposal is submitted to the customer.

Sales Department—This department receives the initial advice of cancellation from the customer and it is their task to immediately provide all interested departments with the information received. For this purpose most companies have devised a prenumbered notice which is duplicated to provide the number of copies required to inform the various departments. To preclude any future question of receipt of notice the recipients should be required to acknowledge receipt.

Failure to promptly notify all departments may give rise to the question, whether items included in inventory were processed subsequent to the cancellation effective date. Moreover, if the Shipping Department is not immediately notified completed items may be shipped to the customer only to have them returned, resulting in unnecessary rehandling effort and unrecoverable shipping expense.

Shipping Department—Upon receipt of termination notice this department will determine whether any units on the subject order are awaiting shipment. If so, the units will be appropriately tagged and forwarded to the Cancellation Stock Room pending customer disposition. Details of the quantities involved will be referred to the Production Planning Department for inclusion in the claim inventory.

Service Department—Customers may have returned product shipped to them prior to cancellation which, at effective date thereof, are either being reworked, or awaiting customers' instructions.

Upon receipt of cancellation notice this department should:

1. Ascertain units on hand pertaining to order cancelled.
2. Submit detailed inventory to the Cost Department for costing and reference to Termination Department.

Production Planning or Production Control Department—This department will upon receipt of a cancellation notice review the production forecast and commitment record to determine status of the order cancelled. Based on this review, the

following steps should immediately be taken:

1. If order is in production, notice issued to halt production.
2. Submit list of commitments to be cancelled to Purchasing Department.
3. Segregate and inventory materials pertaining to the cancelled order.
4. If production schedule indicates that a subcontractor is involved in the cancellation, notice must be immediately sent to the subcontractors advising them to:
   - A. Halt production.
   - B. Segregate and inventory materials on hand.
   - C. Submit costed inventory tabulations.
5. Follow subcontractors for receipt of inventory tabulations.
6. Review and certify all inventories as to propriety of quantities and stage of completion indicated.
7. Submit certified inventories to Cost Department.

Tool Design Department — When properly notified of a cancellation this department will immediately:

1. Stop all tool design, sheet writing and tool room work on the items affected.
2. Prepare listing of open tool purchase orders applicable to the order cancelled, to be submitted to the Purchasing Department for issuance of appropriate cancellation supplements and requests for vendors' cancellation charges.
3. Prepare tabulation of tools in duplicate.
   - A. Original to be forwarded to the Accounting Department for the purpose of entering the cost of tools listed.
   - B. Duplicate to be submitted to the Tool Crib for tagging and segregation of the tools involved.

Purchasing Department—The commitment lists received from the Production Control and Tool Design Departments will furnish the basis for action by this department as follows:

1. Immediately dispatch cancellation telegrams to vendors appearing on the commitment list.
2. Formal purchase order supplement to follow telegram, accompanied by forms for the presentation of vendors' claims and instructions as to procedure to be followed.
3. Follow vendors for receipt of claims or no charge releases.
4. Review and approve all claim forms received from vendors together with recommended disposition of material involved.
5. Transmit approved vendors' claims to the Termination Department.

Accounting Department—Upon receipt of tool lists this department will proceed to price and extend the tool inventory and forward same to the Termination Department.

Cost Department—Certified inventories received from Production Control Department will be processed as follows by this department:

1. Contractor's inventories will be priced and extended.
2. Subcontractors' inventory prices will be verified.

Inventory forms should provide space for indication of the Cost Department's approval.

A statement of tool costs recovered in billing of product delivered prior to cancellation date will be prepared and forwarded to the Termination

Department for determination of total tool cost to be included in the claim.

Termination Department—This department is the consolidation point for certified inventories, vendors' claims, etc. mentioned previously. When all are received the final summary claim forms are prepared and profit and other indirect assessments applied. Extensions and footings of the various statements received are likewise verified by this section.

The Termination Department will be responsible for following-up the various departments to insure that no undue delay occurs at any point in the progression. Where there is any great volume of cancellations a control register will be necessary to reflect at all times the status of claims. As claims are transmitted from one department to the next succeeding department a transmittal form should be prepared, copy of which is sent to the Termination Department for entry of the status change on the control register.

If a normal processing period is established for each department, reference to the control register will reveal those departments which are exceeding the allotted time and creating a bottleneck. In such instances, explanations should be required from the department heads involved.

When the number of cancellations warrant it and where IBM tabulating equipment is available, this record can be maintained by such machines with the added advantage that periodic summary reports can be readily prepared for the information of management.

Auditing of Claims—Under Termination Regulations the prime contractor is required to review claims presented by subcontractors so as to be able to certify that the claim is fair and reasonable. This does not necessarily mean that a field audit will have to be made in each instance but office reviews similar to those employed by the Government in its review of prime contractors' claims are contemplated.

If the contractor's internal audit force is large enough it is advisable to not only review subcontractors' claims but to include as part of regular termination procedure, audit review of all claims before presentation to customers. Such review would insure that all claims filed are complete and that items included and cost applied are supportable and prepared in accordance with recognized accounting practices. From experience I can say that any loss in time resulting from this audit review is offset by the number of questionable items which are thereby eliminated.

While extreme care may be exercised at every step in the preparation of the claim, if it is reviewed in its entirety from an auditor's objective viewpoint, many deficiencies may be disclosed. Critical review of claims before filing, precludes subsequent delay in settlement when Government auditors request supplementary information.

A copy of the internal auditor's report should accompany every claim when presented to management for approval which should bear indication that the Termination Department has reviewed the auditor's comments and disposition made thereof. In most instances, the claim deficiencies will be corrected and the Termination Department will simply place a rubber stamp impression next to the comment, reading, "Subsequently Corrected" together with the initials of the person making the correction.

While company operating conditions will, to a large degree, determine the procedures to be applied in auditing claim proposals a suggested general audit program for office review is presented at the end of this paper.

The extent of field auditing that will be required by the prime contractor of the subcontractors' claims is dependent on the following facts:

1. Amount involved on cancellation.
2. Reputation and integrity of subcontractor involved.
3. Terms of subcontract agreement in effect.
4. Extent of regular field auditing performed prior to termination
5. Extent of auditing to be undertaken by Government auditors.
6. Exceptions disclosed by office review.

1 and 2 require no further comment except to caution that reasonable discretion be exercised. 3 and 4 are related. If the subcontract agreement establishes firm prices which have previously been verified by examination of the subcontractors' records, usually, the only facts to be verified are the existence of the inventory claimed, applicability to the order cancelled and that the inventory is segregated, tagged and protected until taken over by the customer. Moreover, if the contract provides that the prime contractor have a resident representative at the subcontractor's plant he can verify this information. In any event such inventory verification would not require the services of an auditor but could be performed by a traveling representative of the prime contractor's Production Control Department

5—Experience has indicated that on large cancellations various service branches have indicated that they would perform the required field audits and permit the prime contractor to certify the subcontractor's claim subject to the Government audit. In other instances, joint audits by the prime contractor's auditor and a representative of the procurement branch of the service have been made.

6—If the office review of the subcontractor's claim indicates a tendency toward carelessness or that questionable items are included the prime contractor will be wise to have a field audit made.

Contractors are undoubtedly going to call upon the public accounting profession for assistance with their termination problems. While in some instances this may be limited to advisory service, in many cases public accountants will be called upon to render a formal opinion on the claims submitted by subcontractors.

In selecting public accountants to review subcontractors' claims it is usually advisable to engage the firm that has regularly audited the subcontractors' accounts. Being familiar with the company's policies and accounting procedures they should be in a position to perform this work with a minimum expenditure of effort and least inconvenience to the subcontractor.

At the Termination School conducted by the New York District Ordnance Department it was suggested that a definite audit program for review of subcontractors' claims be prepared and submitted to Ordnance Department for approval. It was likewise recommended that a copy of the program be included in the claim papers, checked off to indicate the steps performed.

The Army Air Forces have likewise requested similar information from prime contractors.

The fact that some reports prepared by Certified Public Accountants in conjunction with termination proposals were criticized by Government officials led to the release by the American Institute of Accountants of a bulletin on the subject of War Contract Termina-

tion under the date of April 5, 1944. This bulletin emphasized:

1. Need for full information of Government regulations and interpretations.
2. Need for objective attitude.
3. Need for assumption of proper responsibility. Since the extent of verification will necessarily vary in each instance, details should be indicated in the report. The Committee on Auditing Procedures has recommended that the public accountant should assume no responsibility as to amount of profit claimed.

Whether the audit be performed by an internal auditor or independent auditor the first two points above apply. However, the internal auditor with his company background should be in a position to review the amount of profit claimed. This element of profit is one item which the contractor may have difficulty in justifying.

The fact that a 7% profit factor was considered in estimating the original sales price of the unit cancelled will not constitute sufficient justification for including a similar amount in the settlement proposal. If actual experience under the contract indicates that the unit is being produced at a loss no profit can be allowed.

Whatever profit is claimed, the contractor should have data available to support such amount in order to avoid delay in settlement. The problem is one of estimating the profit which would have been earned had the contract been completed, and proving it to the satisfaction of the Contracting Officer.

Rate of profit realized on a cancelled war contract is often rendered uncertain due to so-called "starting load" costs. Normal cost may not be attained for a considerable period, therefore, it is essential that these costs be carefully recorded, budgeted and controlled.

Contractors must realize that the burden of proof rests with them for indirect assessment rates and profit factors applied. If the accounting system is adequate this will prove to be no particular problem, however, if accounting has not kept pace with productive expansion much difficulty might be experienced. While it is admittedly late in the day to correct deficient accounting systems from a termination viewpoint, the proverb "better late than ever" still holds.

In most instances, it is to the contractor's advantage to settle his claim on the negotiated rather than formula basis. It is essential, therefore, that claims be processed without delay since the Standard War Department's termination clause prescribes that unless cancellation charges are negotiated within 90 days or within any extended limit, which may have been granted by special request, the Contracting Officer at his discretion may refuse to negotiate with the contractor and proceed to effect settlement on the formula basis.

Every effort should be made, therefore, to maintain a close follow-up on each cancellation and where negotiations are not completed within the 90 day period to apply for extension of time to complete the case.

Program for Audit Department's Office Review of Cancellation Claims

1. Review claim for sufficiency of documents.

A. *Inventory Certificate—*
Authority of person signing certification?
Do papers indicate location of inventory?

B. *Vendor's Certification—*
Proper form?
Is purchase order reference given

and material location designated?
Disposition recommended?

C. *Statement of Tooling Cost*—
Actual expenditure shown in addition to authorized budget?
Statement signed?

D. *Subcontractor's Claim*—
Proper form?
Authority of person signing certification?
Location of inventory indicated?
Disposition recommended?

E. *Copies of Cancellation Notices*—
Was notice promptly given?
Does vendor's or subcontractor's claim suggest possibility that work charged for in claim may have been performed subsequent to receipt of cancellation notice?
(Examples: where claim indicates completed units only. Where parts transferred just prior to cancellation date are reported fabricated).

2. Compare total amount of claim with maximum recovery as indicated by the applicable sales order (no. of units cancelled X unit selling price).

3. Compare inventory to bill of material for unit cancelled to determine:

A. That materials in inventory are applicable to the particular unit.

B. Reasonableness of inventory quantities after considering normal allowance for spoilage.

If any quantities are excessive, determine whether justifying explanation is contained in claim's supporting papers.

(Example: minimum mill run, economic purchase quantities, etc.)

4. Check inventory and commitments to production schedule to determine if quantities indicate instances of exceeding schedule.

A. Do quantities exceed C.M.P. limitations?

B. Does production schedule for unit indicate possibility of diversion of material to other orders for same unit?

5. Are unused C.M.P. allotments returned by subcontractors?

6. Review vendors' claims.

A. Do quantities on hand agree with delivery schedule indicated on purchase order?

B. Examine purchase orders for reference to material supplied the vendor by contractor. Does the vendor include such material in his claim?

C. Examine record of contractor's owned materials in the hands of vendors, to determine whether such materials are included as part of our inventory claim.

D. Extraneous vendors' charges should be approved by departments qualified to pass thereon in addition to approval of the Purchasing Department.

7. Verification of inventory costing:

1. Vendors' inventories (review completely).

A. Completed units at purchase order price.

B. Partly complete—percentage of purchase order price based on percentage of completion. Stage of completion reached should be approved by Purchasing and Production Planning Departments.

2. Contractor's inventory (test substantial portion indicating in report % tested).

A. Raw materials and vendor's purchased parts at actual purchase price.*

B. Subcontract purchased parts at purchase price* plus subcontractor's assessment rates.

C. Manufactured Parts — actual material* and labor plus

* Including material burden factor.

burden rate applicable to the manufacturing period.

D. Completed units at sales order price.

3. Subcontractor's inventories (test substantial portion, indicating in report % tested).

These will generally be priced at contract price. Consider date of cancellation to determine contract in effect at the time.

8. Tooling—If statement of tooling costs indicates any tooling applicable to the unit, investigate completely. (Original budget amount, recovered in product billing, actual tooling expense incurred, and inclusion of tooling in cost estimate). On large cancellations where tooling statement indicates no charges applicable, test accuracy of statement as above.

9. Test various assessment rates applied on the claim to the Cost Department's records.

10. All extensions, footings and assessment rate applications should be verified.

11. Scrutinize claim forms for the following:

A. General completeness including approvals by various departments.

B. Correctness of sales order data—date, number, quantities, sales price and cancellation effective date.

12. In reviewing subcontractors' claims determine if any other claims have been previously received. These should be referred to for determination of general background and consistency of his practices.

13. Review material disposals:

Material held in connection with cancellation of customer's procurement should be released only upon customer's authorization with the following exception:

Material may be diverted to another contract of the same customer before any proposal for cancellation settlement has been filed.

A. Diversions:

1. Examine customer's diversion authorization.

2. Examine authorization of other customer to whose order material was diverted.

3. If diverted prior to initial submission of settlement proposal quantities should be applied in reduction of gross inventories. Subsequently authorized diversions should be extended at full costing formula rates and applied as offset to total amount claimed.

B. Disposals:

1. Examine customer's disposal authorization.

2. Examine authorization of sale by War Production Board in accordance with C.M.P. requirement.

3. If sold as scrap, certification should have been received from purchaser that material will be scrapped and not otherwise used.

4. Sale should be consummated on an "F.O.B. point of shipment basis" at price authorized by Contracting Officer. Proceeds should be applied as offset to total amount claimed.

Sources Available for Dividends

By PHILIP TRESTYN

ONE of the most perplexing problems facing the accounting and legal professions in advising corporate clients is the determination of the amount available for distribution to the stockholders. The complex structure of modern corporations and the lack of uniformity of the various statutes of each of the states complicate the problem.

The entire dividend law of the United States may be summed up in the words "dividends may not impair capital". Earnings of a corporation are generally the sole source available for distribution to stockholders. Dividend statutes, however, have created many exceptions to this rule and have extremely weakened it. Surplus, the accumulated profits of a corporation, may be composed of various items which have not actually been earned. These items are generally known as capital surplus. The availability of capital surplus for the payment of dividends has been one of the major items of dispute and diversity among the states. Capital surplus and several other problems of equal complexity have arisen with the modern corporation. The more recent statutes have dealt in detail with these problems. In the absence of statutory provision, the courts have decided the disputed points. Differences of opinion and the failure to establish uniform rules have characterized the decisions of the courts and the provisions of the various statutes.

The rule that the capital of a corporation may not be impaired by the payment of dividends is not absolute or rigid. It is subject to several exceptions and a variety of interpretations.

Determination of legal capital

When capital stock is sold by a corporation, the par value of the shares is very often not received. Shares may be sold at a premium or at a discount and the par value will not represent the actual capital. Corporations are permitted to issue stock for property. The property received is not often equal in value to the par of the stock. Due to the above factors it is often quite difficult to determine the exact sum held for the benefit of creditors.

Several states have clearly defined the capital which was not to be impaired in their statutes. The Uniform Business Corporation Act defines capital as, "the portion of its assets acquired as consideration for shares alloted and that portion of its assets which has been treated as payment for shares allotted as stock dividends."[1] This definition limits the capital to the actual consideration and not the par value of the capital stock.

The Illinois Business Corporation Act defines the capital of a corporation as the par value of the par value stock plus the agreed value of the non-par shares and amounts transferred to capital through stock dividends of otherwise.[2] This definition is a distinct improvement over the vague terms employed in the previous act which was in force prior to 1933.[3] Under the Illinois law, capi-

Second Prize Paper in 1944 Prize Essay Contest.

[1] Uniform Business Act, section 1, subd. XII.

[2] Illinois Business Corporation Act, section 2 (k).

[3] "The capital of the corporation shall be considered as the aggregate amount paid in on its shares of capital stock issued and outstanding." General Corporation Act, section 23.

tal is the par value and not the consideration received for the stock as in the uniform act.

No-par Stock

New York State, in 1912, permitted the use of stock without any par value. The other states quickly followed suit and stock without any par value is now commonly issued.[4] There are actually two types of no-par stock. Stated value non-par stock is stock upon which it is agreed in articles of incorporation that a minimum value must be paid in. True non-par value stock is stock without any value appearing upon the certificate, solely the number of shares.

When no-par stock is issued, the problem arises as to what part of the consideration paid should be transferred to capital and what part to paid-in surplus account. Modern corporation laws realize that it would be unwise to allow an unrestricted allocation of the consideration to be capitalized. A middle ground has been adopted whereby a minimum amount must be placed in the capital account and the remainder may be allocated to paid-in surplus. Few of the laws require that the entire amount received must be capitalized. In all the states it is forbidden to give no-par shares as a bonus.

New York State requires that the entire consideration received for no-par shares be placed in the capital account. Florida and Indiana follow the New York rule. The Uniform Business Corporation Act permits the directors to decide what portion of the consideration received shall be capital. The books of the corporation must clearly show as separate items the no-par capital and paid-in surplus.

Delaware, New Jersey, and Maryland allow the directors unlimited discretion as to the determination of the no-par capital. New Jersey allows the directors forty days after the issuance of the shares to decide upon the capital value.[5] Delaware and other states following the uniform act allow sixty days to the board of directors.[6] Under this provision, the purchaser of the stock has no knowledge as to what portion of his contribution shall be capital. The Securities and Exchange Commission may modify this rule through its strict requirements for the listing of stock.

Michigan requires that the amount of consideration for no-par shares transferred to capital must be equal to at least fifty per cent of the total received.[7] Illinois and California require that a minimum allocation to capital to be equal to at least the sum which the no-par shares will be entitled to upon dissolution. Hills, in his Model Corporation Act, suggests that at least two-thirds of the consideration received be placed in capital.[8]

The tendency with respect to no-par value shares is to allow the directors discretion as to the determination of the no-par capital. The more recent statutes favor some restriction as to the minimum amount to be transferred.

Wasting assets doctrine

A mine by the nature of its opera-

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[4] Delaware General Corporation Law, Laws of 1915, Sections 5, 14, 20.

Illinois General Corporation Law, Laws of 1919, secs. 31-2. Massachusetts General Laws, Laws of 1921, Chapter 156, sections 6 (e), 14.

[5] Revised Code of 1937, Section 14:8-19.

[6] General Corporation Law of 1937, Article I, chapter 65, section 14.

[7] General Corporation Act, as amended to Jan. 1, 1939, section 19.

[8] Hills, George S., "Model Corporation Act", Harvard Law Review, Volume 48, June 1935, p. 1345.

tions reduces its capital assets. The value of the mine is reduced as each ton of ore is converted into inventory and sold. Under good accounting practice, mining companies include in their expenses a fixed charge per unit of ore extracted. This depletion charge is in the nature of a fund to compensate for the sale of the fixed assets of the company. Upon the exhaustion of the mine this fund is employed for the purchase of other mining properties. However, if a company has no intention of purchasing other properties it would be forced to hold this fund until the dissolution of the firm.

Corporation law has developed the wasting assets doctrine with respect to mines. This doctrine would permit the payment of dividends from capital in a wasting assets corporation. The underlying theory is that the stockholders and creditors realize that the receipts from sales of ore are in part profits and in part a return on the investment. Corporation law allows the payment of dividends, in a wasting asset corporation, not only from profits but also from the reserve for the depletion of the mine.

At the present time, the wasting assets doctrine is upheld in almost all cases. It is held to apply to mines, timber tracts, quarries and oil wells. In one case it has been held to apply to companies operating on a patent or leasehold.[9] An exception to the rule is that a corporation may not sell its properties or even a portion of them and declare a dividend from the proceeds.[10] Ballantine and Hills have suggested that a company which owns several mining properties and continually invests in others should not be permitted to declare dividends from capital.[11] They believe the wasting assets doctrine should apply solely to companies exploiting a specific piece of property. This view is logical since the mining companies had claimed that unless they were allowed to declare dividends from capital, they would be forced to accumulate large sums of money which they had no means of putting to use if they did not wish to purchase new mining properties.

The wasting assets doctrine has been attacked also upon the ground that it gives the stockholders the impression that a company has large profits when it is actually declaring dividends from capital. In an article from the Harvard Law Review, the author states, "This distinction rests on the theory that a mining business necessarily exhausts its capital . . . profits so calculated consist partly of capital which stockholders may be misled into spending as earnings."[12]

The courts of New York in 1898 upheld the wasting asset doctrine in the case of People ex rel United Verde Copper Company *v.* Roberts, in the absence of any statutory provision.[13] In 1926, in the case of Wittenberg *v.* Federal Mining and Smelting Company, the Delaware courts decided that unless the statutes specifically exempted mining companies from the necessity of providing a reserve for depletion, no dividends could be paid from capital by a wasting asset company.[14] Imme-

[9] Excelsior Water Mining Co. *v.* Pierce, 90 Cal. 131 (1891).

[10] Fletcher, W. M. (cp.cit.) sec. 5347.

[11] Ballantine, H. W. and Hills, George S., "Corporate Capital and Restrictions on Dividends", California Law Review, Vol. 23, March 1935, p. 253.

[12] Anon, "Corporations-Dividends-Allowance for Depletion by Mining Corporations", Harvard Law Review, Vol. 40, February 1926, p. 318.

[13] People ex rel. United Verde Copper Mining Co. *v.* Roberts, 156 N. Y. 585, 51 N. E. 293, (1898).

[14] Wittenberg *v.* Federal Mining and Smelting Co., 15 Del. Ch. 147 (1926).

diately after this decision, Delaware enacted a statute providing for the wasting asset doctrine.[15] The same case was again heard in 1927, after the enactment of the statute, and the corporation was permitted to declare dividends from capital.[16]

The Supreme Court of Delaware is the sole court to have held that there must be a statutory provision for the wasting asset doctrine to apply. New Jersey, which has no statute of this type, permitted dividends from capital in a recent case.[17] Many states however have enacted statutes of this nature.

The Uniform Business Corporation Act provides that a corporation which owns wasting assets need not take depletion.[18] Arkansas, Delaware, California, Georgia, Idaho, Indiana, Louisiana, Minnesota, Mississippi, Ohio, Pennsylvania, Washington, and West Virginia have statutes to the same effect.

Ohio, Indiana, and Louisiana require in addition that unless the articles of incorporation state that no deductions shall be made for depletion, no dividends shall be paid from the depletion reserve.[19] The California statute provides that the stockholders should be notified as to what percentage of their dividends are from profits and what percent from capital.[20] A provision of this nature prevents the stockholder from spending the entire dividend under the mistaken impression that it is profit of the corporation.

The wasting assets doctrine may not be applied, even though permitted by statute, in one instance. When a corporation has preferred stock which is entitled to a preference as to assets upon dissolution, the capital of the corporation must be kept intact. It would be unfair to pay dividends on the common stock so as to reduce the assets available for the preferred stock upon dissolution. The courts have upheld this rule.[21] The Uniform Business Corporation Act allows dividends from capital subject to the rights of shareholders of different classes.[22]

Legal reduction of capital

It is a simple matter under present statutes to legally reduce the capital. Ratification by the majority of shareholders is often enough authority. The stockholders are given the power to reduce the capital which is maintained for the protection of the creditors. The sum by which the capital is reduced is transferable to surplus and may be paid out to the stockholders as a dividend in many states. During the depression it was the common practice to wipe out deficits by transfering large sums from capital to surplus.

Reduction in capital is most often accomplished by mere formal steps such as a vote by the board of directors, action by the stockholders, and the mailing of notices to creditors. Several forms of protection for the creditors are in existence in the statutes of most of the states.

In Wisconsin, the stockholder who votes for a reduction of capital is liable to the unpaid creditors to the full extent of dividends received

[15] General Corporation Law, Section 35.

[16] Federal Mining and Smelting Co. *v.* Wittenberg, 15 Del. Ch. 409, 138 A. 347 (1927).

[17] DeBrabant *v.* Commercial Trust Company of New Jersey, 113 N. J. Eq. 215 (1933).

[18] Uniform Business Corporation Act, Section 24.

[19] Ohio General Code, section 8623-38; Indiana General Corporation Act, section 12, Indiana Acts 1929; Louisiana Business Corporation Act, Laws of 1928, act 250, section 26.

[20] Civil Code of California, section 346, as amended by laws 1933, chapter 533, section 49.

[21] Wittenberg *v.* Federal Mining and Smelting Co. 15 Del. 147 (1926).

[22] Uniform Business Corporation Act, Sec. 24, subd. VII.

from the reduction of capital.[23] The statutes of West Virginia provide that the unpaid creditors may recover from the stockholders any surplus received on the reduction of the capital.[24] The other states have no provision for the liability of the stockholders to the creditors.

The states of Idaho, Louisiana, Maryland, Minnesota, Nevada, New York, South Carolina, and Washington provide that after reduction, the assets of the corporation must exceed the liabilities plus the reduced capital. This protection for the creditors is inadequate as any solvent corporation can always have assets in excess of liabilities.

In the states of Arkansas and Florida it is required that a minimum capital of $300.00 and $500.00 respectively must be maintained.

The capital stock as reduced must exceed the existing liabilities in Missouri, Montana, Tennessee, and Wyoming. A statute of this type affords some protection to the creditors as the capital fund can not be less than the debts. Utah is more conservative and provides that the reduced capital must be fifty per cent larger than the liabilities. The capital must exceed the liabilities plus the contemplated fixed investments in North Dakota, Oklahoma, and South Dakota.

Upon reduction of capital, the sole requirement in Colorado, Connecticut, Delaware, Illinois, Maine, Massachusetts, Nevada, New Hampshire, Ohio, and Rhode Island is that the corporation must be solvent. The criticism of this provision is that the current solvency does not insure further solvency. California, in addition to the solvency requirement, provides that the assets must exceed the liabilities by one-fourth. This type of statute would be more effective if it took into consideration the fact that fixed assets are worth little upon the dissolution of a business and would not satisfy the claims of the creditors.

In Nebraska and Virginia creditors are protected by the undefined statement that the rights of the creditors must not be affected by a reduction of capital. This is too vague and indefinite.

There is no requirement, aside from certain formalities for the reduction of capital in the states of Alabama, Arizona, Kansas, Kentucky, Michigan, Mississippi, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, and Vermont.

Problems Under Net Profits Statutes

The statutes of several states provide that dividends may be paid from the net earnings of a corporation. What constitutes net earnings is a matter upon which competent authorities will differ widely. Fixed rules are not available as the determination of profit is largely a matter of opinion as well as fact. The true value of a business can only be determined upon liquidation of the enterprise. The courts often do not follow the best accounting practice and sometimes hold to antiquated rules. It was not until 1897 that the courts recognized the necessity of providing for depreciation of fixed assets.[25]

Many corporations have maintained a record of regular payments of dividends for a number of years. When the depression began in 1929, it was thought to be temporary and those companies desired to pay dividends in spite of decreased profits. Railroads accomplished this by reducing the maintenance of their assets

[23] Wisconsin Code of 1931, Section 182.08.

[24] Mitchies' Code of 1932, Section 3026.

[25] Reiter, Prosper Jr., "Profits, Dividends, and the Law." (Ronald Press, N. Y., 1926) page 127.

From 1929 to 1933 maintenance in class I Railroads was curtailed drastically. In 1930 more dividends were paid by the railroads than at any time since 1920. It is obvious that some of the dividends were derived from the decline in maintenance expense.[26] Public utility companies were found to be failing to make adequate repairs and reducing depreciation rates.

Holding company profits

The modern trend of corporate organization is for the employment of complicated holding company structures. A problem that has arisen and not yet litigated is the possibility of the routing of earnings from one subsidiary to another. A holding company, controlling two subsidiaries, may have one of the subsidiaries sell to the other at a price which results in a large profit for the seller and a loss for the purchasing company. The subsidiary could then declare dividends from the artificial profits.

Several abuses of the holding company's power over its subsidiaries have been uncovered. In 1930 the Gillette Safety Razor Company transferred inventory to subsidiaries yielding a large paper profit. The subsidiaries of course suffered a loss.[27]

The United States Leather Company created a subsidiary and sold its capital assets at a large profit. It intended to distribute the profits and wipe out the arrears on the preferred stock. Reorganization of the company prevented a legal test of the practice.[28]

Dividends from earnings in spite of deficit

Statutory provisions of several states permit the payment of dividends despite the fact that the capital has been impaired by operating losses of the previous years. The underlying theory is that it would be an undue hardship to have the corporation make up a deficit out of earnings while the shareholders receive no share of the current profits.

The states of California, Delaware, Georgia, and Minnesota have adopted statutes permitting dividends from current earnings in spite of a deficit. Delaware permits the payment of dividends from "its net profits for the fiscal year then current and/or the preceding fiscal year."[29] This means that not only the current earnings but the earnings of the next previous period are available for distribution.

The sole protection afforded the stockholders from the dilution of capital is the provision that the capital may not be diminished below the amount representing stock having a preference upon the assets upon dissolution. Section 34 of the Delaware General Corporation Act states:

> "If the capital . . . shall have been diminished . . . to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets should be repaired." •

[26] Dewing, A. S., "The Financial Policy of Corporations" (Ronald Press, N. Y., 1934) p. 610.

[27] Berle, Adolf A. Jr., and Means, Gardiner C., "The Modern Corporation and Private Property" (Macmillan Co., New York, 1934) p. 204.

[28] Dewing, A. S. (op. cit.) p. 603.

[29] General Corporation Law, section 34.

The statutes of California Georgia, and Minnesota have protection for the preferred stockholders to the same effect as the Delaware statute. It does seem fair to allow the common stock dividends while the capital is impaired since they take the risk that dividends may not be paid to them even when they are earned.

Problems Under Surplus Statutes

Prior to modern corporation laws it was sufficient to state that no dividends could be paid unless the assets exceeded the liabilities and capital. The excess was surplus. Statutes were then drafted which stated dividends were to be paid solely from surplus. However, with the growth of no-par issues, new types of surplus arose. These types of surplus were neither surplus nor capital but were grouped under the heading of capital surplus. Earned surplus is defined as "the balance of net profits, income and gains of a corporation from the date of incorporation, after deducting losses, and after deducting distributions to stockholders and transfers to capital stock account made out of such surplus.[30]" All surplus items aside from earned surplus is available for dividends except for express provisions to the contrary.

Recent corporation statutes have full provisions dealing with capital surplus. New York has no provisions dealing with capital surplus and thus all surplus items are available for dividends. Delaware is an example of extreme freedom in that it permits dividends whenever the net assets exceed the capital of a corporation. Indiana, Maine, Nevada, and Ohio permit dividends from any type of surplus. The majority of the states provide that dividends shall be paid solely from surplus profits. This type of provision does not permit distribution of capital surplus. Several states have statutes specifying that dividends should be paid solely from earned surplus, among them being Arizona, Arkansas, California, Kansas, Michigan, Minnesota, South Carolina, Tennessee, and Virginia.

Capital surplus is subdivided into various items all derived from different sources. These items have in common the fact that they were derived otherwise than through a transfer of profits to surplus. Capital surplus is not earned in the regular course of business.

The trend in corporation laws is toward approval of distributions of capital surplus. In 1909 the New York Penal Law permitted dividends only from the "surplus net earnings arising from the operation of the business."[31] This provision excluded capital surplus as a source for dividends. In 1924 this section was amended outlawing dividends "except from surplus".[32] Obviously the purpose of the amendment was to allow distributions from capital surplus.

Premiums on capital stock

A premium on capital stock is a payment by a purchaser of stock of a sum in excess of the par value of the stock and in excess of the amount transferred by the corporation to the capital stock account. This excess is part of the capital surplus and is called paid-in surplus. A premium on capital stock may arise in the following fashions: Upon the organization of a corporation a purchaser may be required to pay a sum in excess of the par value of his shares, after successful operations a corporation may have built

[30] Heckert, J. B. "Comments on Definitions of Earned Surplus", American Accountant, June 1930, p. 173.

[31] Penal Law, section 664, subd. 1.

[32] Laws of 1924, chapter 221.

up a large earned surplus and a new purchaser of stock will be required to pay a sum equal to the par value plus the earned surplus, when no-par shares are issued a part of the contribution may be segregated as surplus by the board of directors.

A premium on capital stock received upon the original issue of shares is treated in different fashion in every state. In a California case, Merchants' and Insurers' Reporting Co. *v.* Schroeder, only a paid-in surplus existed and no profits had as yet been earned. The court forbade dividends from the premium and stated that it was part of the capital stock.[33] California has adopted this rule by statute.[34]

New York employs the rule that all premiums on capital stock, regardless of the time received, are available for distribution. Prior to the 1924 amendment, liberalizing the New York dividend statutes, it was held that although a premium on capital stock was not surplus it could be subject to division among the stockholders.[35] Other cases have failed to distinguish between the types of premiums on stock and have held them all available for dividends.[36]

When a premium is paid on the stock of a going concern it is considered as an equalizing fund to place the incoming shareholder on a par with the old ones who have an accumulated surplus to their credit. The courts agree that it is fully available for dividends and have so held in Equitable Life Assurance Society *v.* Union Pacific Railroad Co.[37]

Paid-in Surplus

Paid-in surplus, or capital surplus, has been recognized by modern corporation laws as an item differing from earned surplus and capital. The recent corporation laws provide for a segregation of the surplus into earned and paid-in classifications. There is also an increasing number of provisions for the notification of the stockholders as to the particular source of each dividend, whether derived from current earnings, earned surplus, or paid-in surplus.

Such items as premium on stock, surplus on stock donations, surplus on reduction of capital, and all other unearned items fall within the classification of paid-in surplus.

Under recent statutes capital surplus assumes the characteristic of a margin or reserve for the protection of the creditors. It is not formally capital and yet is not as fully available for dividends as earned surplus.

The Illinois Business Corporation Act provides that dividends from paid-in surplus are limited to the preferred shareholder.[38] In addition notice must be given to the stockholder as to the source of his dividend. The General Corporation Laws of Michigan permit stock dividends from capital surplus.[39] This is based on the theory that a stock dividend is simply a transfer of surplus to capital. If unearned surplus is actually capital there is no harm in so transferring it by means of a dividend.

Restriction of paid-in surplus to preferred shares and stock dividends are the sole restrictions in the majority of states.

[33] Merchants' and Insurers' Reporting Co. *v.* Schroeder, 39 Cal. App. 226, 178 Pac. 540 (1918).

[34] Section 309, California Statutes.

[35] People ex rel Queens County Water Company *v.* Travis, 157 N. Y. Supp. 943, aff'd 219 N. Y. 571 (1916).

[36] Smith *v.* Cotting, 231 Mass. 42, 120 N. E. 177 (1918).

[37] Equitable Life Assurance Society *v.* Union Pacific Railroad, 212 N. Y. 360, 106 N. E. 92 (1914).

[38] Illinois Business Corporation Act, Laws 1933, Section 41 b.

[39] General Corporation Laws, Laws of 1931, section 20.

Revaluation surplus

The value of the assets of a corporation frequently fluctuates for various reasons. Securities owned may vary in value each day. Upon the appraisal of a fixed asset it may be found to be worth a great deal more than the depreciated value on the books. A corporation may record this rise in value by crediting the excess to surplus. Corporation laws however do not consider such appreciation surplus to be available for dividends as earned surplus.

Appreciation that is actually realized is available for dividends in all states without exception. In People *v.* Sohmer, the company had purchased a lease for $200,000 and later sold it for $1,050,000. The court upheld the dividend from this source and said the appreciation was surplus profits.[40] The general rule was stated in one case as follows:[41]

> "An appreciation in value of assets may be taken into account in determining whether or not a profit has been made, and may be distributed as dividends in the same manner as profits arising from earnings, where such appreciation has been actually realized."

In the absence of statute, unrealized appreciation is not available for dividends. In the case of Jennery *v.* Olmstead the court held that the difference between the purchase price and market value of bonds is not a profit until the bonds are sold.[42] Many other cases have applied the same rule. In Southern California Home Builders *v.* Young, the court held that the estimated profits on uncompleted contracts were not profits and could easily become losses if the estimates were inexact.[43] The general rule was stated in Kingston *v.* Home Life Insurance Co. in the following words:[44]

> "If it is an investment of the company, its increased value when realized by a sale may perhaps be treated as a profit but until realized it is surely unwise, inaccurate and wrong to so regard it and pay out money based on such an estimate, for it is only a guess, and if a correct one may become incorrect later when the conditions which produced the estimated increase of value change."

In the case of Moore *v.* Murchison the corporation purchased assets for $7,800 and set them up on their books at $15,000. Upon the bankruptcy of the company, the directors were sued and held liable for the amount of the dividends they had declared from the revaluation.[45]

There have been several exceptions to the rule forbidding dividends from unrealized profit. In State *v.* Bray, the court approved dividends when it was shown that the replacement value exceeded the appreciated value of the assets.[46] An appraisal company revalued the property of a corporation in the case of Splittberger Brothers *v.* Skinner Packing Co., and the court held that directors who had valued property honestly were not responsible if the same property later became worthless due to no fault of their own.[47] Common law approves of the issuance of stock dividends for realized appreciation.

[40] People *v.* Sohmer, 143 N. Y. Supp. 313 (1913).
[41] Equitable Life Assurance Society *v.* Union Pacific Railroad Co., 212 N. Y. 360 (1914).
[42] Jennery *v.* Olmstead, 36 Hun 536 (1885).
[43] Southern California Home Builders *v.* Young, 45 Cal. App. 697 (1920).
[44] Kingston *v.* Home Life Insurance Co. 11 Del. Ch. 258 (1917).
[45] Moore *v.* Murchison, 226 Fed. 679 (1915).
[46] State *v.* Bray, 20 S. W. (2d) 56 (1929).
[47] Splittberger Brothers *v.* Skinner Packing Company, 228 N. W. 531 (1930).

No one is injured by such dividends as the property could be sold to another corporation for the appreciated value. In the case of unrealized appreciation, a stock dividend would merely reduce the value of each share and proportionately increase the number of shares. In Berwind White Mining Company *v.* Evart, a stock dividend was permitted from unrealized appreciation.[48]

A stock dividend may be fraudulent through the impression given by a dividend that the corporation is earning profits. In one case a corporation wrote up the value of a leasehold to six times its book value and declared a 150 per cent stock dividend. [49] The court enjoined the dividend.

In recent years statutory provisions have appeared regulating the payment of dividends from unrealized appreciation. The two extremes of the statutes are represented by Wisconsin and Ohio. Wisconsin specifically permits cash dividends from unrealized appreciation.[50] Ohio forbids all types of dividends from revaluation surplus as does California.[51]

The Uniform Business Corporation Act permits stock dividends from unrealized appreciation. Alabama, Arkansas, Florida, Idaho, Illinois, Louisiana, Maine, Maryland, Nevada, Ohio, Pennsylvania, Tennessee, Washington, and West Virginia permit stock dividends by statute, directly or indirectly. New York allows stock dividends, although not by statute.

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[48] Berwind White Mining Co. *v.* Evart, 33 N. Y. Supp. 716 (1895).

[49] Pontiac Packing Co. *v.* Hancock, 257 Mich. 45 (1931).

[50] Wisconsin Statutes, Laws 1931, section 182.19.

[51] Ohio General Corporation Act, Laws 1927, Section 38 California Civil Code, Laws 1933, c. 533, section 49.

Contract Termination—Presentation of Statement of Costs

Total Costs vs. Inventory Method

By Joseph J. Wagner, C.P.A.

THE Contractor's proposal for settlement of a terminated war contract is largely based on the contractor's own charges as presented in his statement of costs. One of the first questions which a contractor must answer before he submits his costs pertaining to the uncompleted portion of a terminated contract is "What method shall I use, the total cost or the inventory method?" Only by understanding the basis and relative advantages of each method can the contractor and his accountant determine which method is best suited to the particular contract which has been terminated at the option of the Government. Theoretically, no matter how the contractor presents his cost, there should be no difference in the final result regardless of whether the total cost method or the inventory method is the basis for the statement of costs. The method to be used depends upon the particular circumstances relating to the terminated contract and it may be more advantageous for a contractor to use one method rather than the other.

The contracting officer is required to send to the contractor instructions in regard to termination of a lump-sum supply contract. The form for these instructions is set forth in paragraph 6 of section VII of War Department Procurement Regulation 15, and accompanies each Notice of Termination. Paragraph 3 of the instructions explains that "the statement of costs may be prepared either on the inventory basis shown in Exhibit 1, Schedule F, or on the 'total cost' basis shown in Exhibit 1, Schedule G. If prepared on the 'total cost' basis, the statement will nevertheless be supported by adequate inventory and other schedules. The inventory method is preferred where the necessary cost information is reasonably available." Thus, the contractor is given the prerogative of choosing either the total cost basis or the inventory basis to present his own termination charges. The technical services of the War Department may, however, require a contractor to prepare his statement of charges on the inventory basis. This provision is generally reserved for those instances where a contractor has adequate cost accounting data.

Under the inventory method, the statement of cost includes the dollar totals of the various classes of inventory, administrative expense, and other costs; to this is added the contractor's profit, if any. The total cost method provides that all of the contractor's own charges incurred on the terminated contract to date of termination—both as to the completed portion and the uncompleted portion of a contract, be included in the statement of costs. Profit allowance, if any, applicable to these costs is added, and then a deduction is made for the selling price of completed units. If there is any indicated loss on the contract, the selling price for completed units is adjusted by increasing it to the cost, thus, the remainder will represent the amount applicable to the uncompleted portion of the contract.

Third Prize Paper in 1944 Prize Essay Contest.

In general, the inventory method should be used when the inventory consists largely of raw material and purchased parts on which little or no work has been performed, and when there is reliable unit cost information available to establish the cost of work in process. The total cost method should be used in the absence of unit cost data, and when the contract is terminated in the early stages of performance. The contractor is often forced to adopt the total cost method when it is difficult to segregate costs between the completed and uncompleted portions of the contract.

When a Government contract has been terminated at the option of the Government under the termination clause, a contractor will find himself in one of the following three situations:

1. He may have inadequate accounting records.
2. His accounting records will cover the overall business.
3. The accounting records will show costs applicable to particular contracts or jobs.

When there are no records or accounting is made on an overall basis, the contractor should first take a physical inventory and then price the material on the first-in, first-out basis by checking to the most recent invoices. Expenses applicable to the uncompleted portion of the contract may be determined by calculating various rates based on the overall totals of applicable expenses to over all production costs. To estimate the cost of direct labor on work in process, the contractor should break down the various labor operations necessary to complete the article, make time studies of the operations and apply labor rates to the extent of the stage of completion of the work in process inventory.

Unless the contractor has a cost system which will furnish complete and accurate costs applicable to the uncompleted portion of a terminated contract, it is generally advisable to prepare the statement of costs on the total cost basis. There are relatively few contractors who maintain their accounting records in such a manner as to record costs on an individual contract basis. Increased war time production and lack of accounting personnel have forced most Government contractors to keep their costs on overall business. The total cost method however, is inconvenient, especially when the contract has been largely completed and it is necessary to accumulate considerable accounting data covering a long period of time. There is always the danger of omitting an important item of direct or indirect cost and it may be difficult to apportion certain indirect charges between other contracts and the terminated contract.

Every contractor before preparing his statement of costs should give considerable thought to the method to be used, as it may mean a saving of valuable time on the part of accounting personnel. The use of one of the two methods may actually result in a more equitable basis for settlement. The price and quantity of inventory, starting load costs, loss on facilities, allocation of expenses between completed and uncompleted portions of a contract, and profit are very important elements in contract termination claims. There are relative merits to the use of the inventory or total cost method relating to the above elements.

Inventory

In most cases contractors' termination charges consist largely of inventory. Under the inventory method raw materials, purchased parts, work in process and production equipment are listed on inventory schedules and the summary totals are included in the statement of costs. Therefore, it is important to include all the in-

ventory applicable to the uncompleted portion of the terminated contract. Unless the contractor has a reliable perpetual inventory for the terminated contract, it will be necessary to take a complete physical inventory in order to include all the items for which a claim is to be presented. The contractor is also required to submit inventory schedules when the total cost basis is used; however, if an item is inadvertently missed during the taking of the physical inventory, it will not affect the statement of costs as the total cost of materials is not based upon a physical inventory but upon available accounting records of items purchased and drawn from stock for the terminated contract.

It is necessary to price the inventory accurately under the inventory method as the extensions of the physical quantities by the unit price represents the cost of the inventory entered on the contractor's statement. One of the main reasons for using the total cost method is the lack of unit cost data to price the inventory, thus, in many instances, prices for various inventory items may be estimated.

Starting Load Costs

In most contracts there are initial costs which are a result of unfamiliarity with the production of the items. Such non-recurring costs as preliminary training of labor and large rejects of material are allowable termination costs. The equitable allocation theory of costs, i.e. each unit should bear an equal portion of costs which benefit the entire contract, is a recognized accounting practice, and therefore starting load costs may be allocated in part to the uncompleted portion of the contract.

Many contractors who prepare their statement of costs on the inventory basis forget to include a proper proportion of starting load costs in their termination costs. Even if it is realized that there are starting load costs, it is extremely difficult to determine the amount applicable to the uncompleted portion of the contract. A production schedule showing the actual unit costs of completed items in chronological order may be presented. If sufficient units have been completed to show the normal production cost, then such normal cost may be used as the basis for establishing the amount of starting load costs. The contracting officer may still question this calculation on the grounds that excessive initial costs due to gross inefficiency are rightfully costs of completed units and cannot be considered as termination costs.

Under the total cost method there is no need to determine the amount of starting load costs and then apportion this to the uncompleted portion of the contract. All costs incurred to date of termination are included on the total cost basis and the proper amount of starting load costs, if any, is included in the remainder, after profit has been added and selling price of completed units deducted.

Loss on Facilities

Any special facilities acquired solely for the completion of the contract and which are not reaonably capable of use in the other business of the contractor may be included as a termination charge. The amount is subject to the limitation on such costs as set forth in Paragraph 1 (i) of the Statement of Principles for Determination of Costs. Under the total cost method the entire cost of such facilities are included in the statement and there is no necessity to apportion the loss of useful value between the completed and uncompleted portion of the contract. Under the inventory method the amount for loss on facilities, to be included as other costs in the contractor's statement, must be de-

termined on the ratio of the deliveries not made under the contract to the total of the deliveries which have been made and would have been made had the contract and other contracts been completed.

Allocation of Expenses Between Completed and Uncompleted Portions of a Contract

When all costs incurred on a contract are presented in the statement of costs, it is necessary to allocate direct charges and to apportion indirect expenses to the particular terminated contract. For example, an analysis of the factory labor account may show that certain laborers worked directly on the terminated contract and therefore their wages are direct costs. Other employees may have worked directly on other contracts and their wages are not to be included in the termination costs. Then, there may be other workers who spent part of their time on the terminated contract and the remainder of their time on other work, their wages must be apportioned on some sound equitable basis to the terminated contract. The last type of labor charge is that which is incurred on operations which cannot be directly attributable to any particular job or contract, but which does benefit the overall operations. Here again, the cost must be apportioned in accordance with acceptable accounting practice.

The apportionment of expenses to a terminated contract when the total cost method is used may therefore involve a complete analysis of all accounts to ascertain what amount is applicable to the terminated contract. This is a difficult task if there is no reliable cost system kept on a contract basis. The contractor may have to rely in numerous instances on rough estimated bases of apportionment which may make it necessary for the contracting officer to spend considerable time in auditing the contractor's records in order to arrive at a fair basis for negotiation.

The inventory represents the major part of the termination costs under the inventory method and usually there are few expenses which pertain to the uncompleted portion of the terminated contract. These expenses can readily be apportioned on the basis of overall relationships, for example if handling and warehousing charge is $1.00 per thousand board feet on all lumber, then this rate may be applied to the inventory of lumber included in a termination claim.

Contractors often fail to consider such charges as handling and warehousing which are applicable to the inventory. Under the total cost method the total charge is included and thus, the contractor gets the benefit of having the proper amount of this type of expense included in his termination claim. Under the inventory method, many contractors do not feel that the determination of such expenses attributable to the purchase, handling, and storage of the inventory warrants the effort necessary to arrive at a fair amount.

Profit

The item of profit in a termination claim based either on the inventory or total cost method, is probably one of the most important elements to be considered by both the contractor and the contracting officer. The calculation of profit which is based on the indicated rate necessarily involves an estimate of the total cost to complete the contract. If the contract is terminated near the start, the longer the period of time it would have taken to complete production, the greater the uncertainty of future costs.

The first question to be answered is "What is the basis for calculating profit?" The new uniform termination article states in paragraph

(c), (the negotiation paragraph) that the amount for termination of work "may include a reasonable allowance for profit". Paragraph (d) (the formula paragraph) of the article provides for the insertion, at the time of awarding the contract, of an agreed percentage up to two (2) percent on the cost of articles or materials not processed by the contractor; and an agreed percentage (no limitation) on the remainder of termination costs. There is an overall limitation of six (6) percent. The percentages which are inserted in the article are agreed upon by the contractor and the contracting officer. In general, two (2) percent and eight (8) percent are used; however, the contracting officer is ordinarily guided by the percentage of profit shown in the contractor's bid cost estimate, by actual profit earned on preceding contracts, and by profit allowed in renegotiation. If it appears that four (4) percent is a fair profit on the contract, it would be to the benefit of the contractor if eight (8) percent was included in the article for termination costs other than unprocessed materials. Even though the formula method and the related percentages do not bind the contracting officer in arriving at a negotiated settlement, there is no doubt that he will be influenced by the percentages originally agreed upon. As a matter of fact, the contractor may insist upon a formula settlement if the indicated rate of profit is lower than the stated percentages and the contracting officer insists upon negotiating a rate below the fixed formula percentages.

The effect which the fixed percentage inserted in the termination article has upon settling contract terminations by negotiations is increasing in importance as contracts which include the new uniform termination article are terminated. The old termination article which is included in many uncompleted contracts did not contain fixed percentages, but provided in the event of failure to negotiate for a formula to calculate the amount of profit on the uncompleted portion of the contract. This formula required an estimate of the profit which would have been realized on the uncompleted portion of the contract multiplied by an estimate of the percentage of completion of the uncompleted portion of the contract.

It is the responsibility of the contractor to calculate the amount of profit on a terminated contract and to attach an explanation of the basis of arriving at such amount. The Government auditor in his accounting report to the contracting officer includes comments, in reasonable detail, upon the bases for the determination of the rate or rates of profit used in the computations. He also points out any special factors relating to the allowance of profit such as the extent to which technical study and supervision and other services involving special skill and knowledge have been performed by the contractor in the engineering work, production scheduling and planning.

The indicated rate of profit which is used to calculate the amount of allowable profit is predicated on the theory that a contract should be considered in its entirety and that all units of production earn an equal amount of profit. The indicated rate is based on the actual costs incurred to date of termination plus the expected costs to complete the contract. As can readily be seen, the rate of profit is largely subject to negotiation upon the part of the contracting officer and the contractor. In too many instances due to the lack of sufficient and adequate accounting data the profit rate has been agreed upon by a bargaining method based on rough estimates, rather than arriving at a fair rate based on actual costs incurred and

reasonable expected costs necessary to complete the terminated contract.

In the determination of profit in connection with negotiated settlements the contracting officer is required by Procurement Regulation 15 to agree only to such allowance of profit as is fair in the light of work actually done by the contractor and materials actually obtained or furnished. A single rate of profit or different rates to be applied to the several classifications of the contractor's costs may be used. If different rates are used, the weighted average of these rates should not exceed the indicated rate.

Under the inventory method, profit which is added to the costs is based on a negotiated rate or rates taking into consideration the extent and type of work done, and the indicated rate of profit.

On the total cost basis profit is calculated on all costs incurred to date of termination. It is difficult to arrive at different rates of profit to apply to various classifications of cost, therefore, a single overall rate is usually negotiated. Some contracting officers instead of adding profit to the cost, reduce the selling price of completed units to cost and deduct this amount from the total cost to arrive at the cost applicable to the uncompleted portion of the contract. Then a profit which may be calculated on one rate or various rates is applied to the termination costs.

The application of the rate of profit is very important under the total cost method. Let us assume that in the following examples that five (5) percent is the fair indicated rate:

	Total Cost Method*	Inventory Method†	Total Cost Method*	Inventory Method†	Total Cost Method*	Inventory Method†
Cost	$10,000	$200	$10,000	$200	$10,000	$200
Profit rate	4%	4%	5%	5%	6%	6%
Cost plus profit ..	$10,400	$208	$10,500	$210	$10,600	$212
Selling Price of Completed Units	10,290	—	10,290	—	10,290	—
Termination Claim	$ 110	$208	$ 210	$210	$ 310	$212

* Total to Date of Termination.

† Uncompleted Portion of Contract.

It can be readily seen from the above three cases that the rate of profit which is used has a great effect on the amount of the termination claim for the contractor's own charges. If the total cost method is used, it is very important to negotiate a fair rate of profit.

Conclusion

Before arriving at a decision as to whether the inventory or total cost method is to be used as the basis for preparing the statement of costs, the contractor and especially his accountant should give due consideration to all the factors involved in the particular termination.

The following is a guide to assist the contractor in making his decision as to this important matter:

	Use Inventory Method	Use Total Cost Method
1. Costs applicable to uncompleted portion of contract represent mostly raw materials and purchased parts unprocessed by the contractor.	X	
2. Substantial amount of work in processs and accurate detailed unit cost data available to price such inventory.	X	
3. Contract terminated in the—		
early stages of performance.	X	
later stages of performance.		X
4. Absence of unit cost data.		X
5. Difficult to segregate costs between the completed and uncompleted portions of the contract.		X
6. Unabsorbed starting load costs and other costs which benefit the entire contract.		X

The inventory method is usually the easier method to use and does not require as much cost data to prepare the statement of cost as does the total cost method. The mere fact that the word inventory is used to denote the type of method does not limit the inclusion of termination costs to inventory only. Such costs as initial cost, loss of facilities and experimental and research expenses which are applicable to the uncompleted portion of the terminated contract may properly be included in the statement of cost prepared on the inventory basis. Under both methods, it is necessary to present inventory schedules and to know the total costs to date of termination in order to arrive at an indicated rate of profit.

The prime objective of the Government in settling contract termination proposals is rapid and fair settlement; this can only be achieved if the contractor promptly submits his inventory schedules, statement of cost, and proposal for settlement Either the inventory method or the total cost method may be used. The only requisite is that the method used furnish a basis for negotiation to arrive at a settlement which is equitable to both the contractor and the Government.

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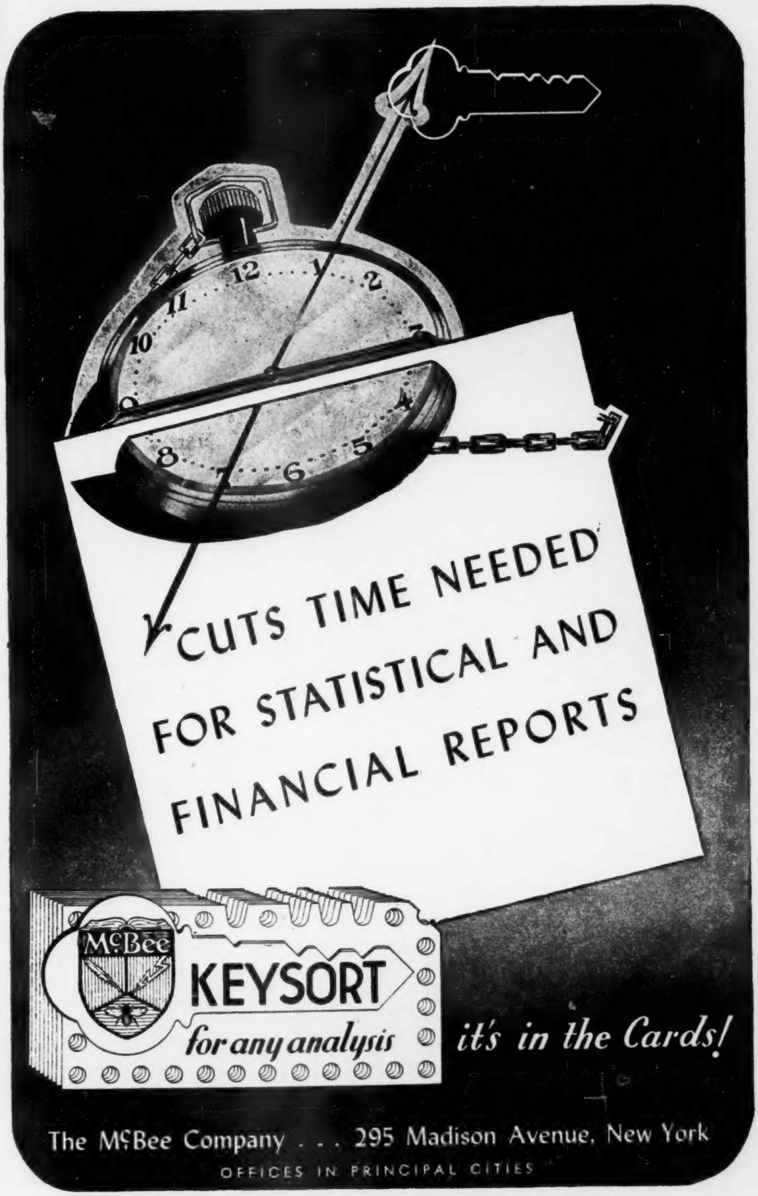
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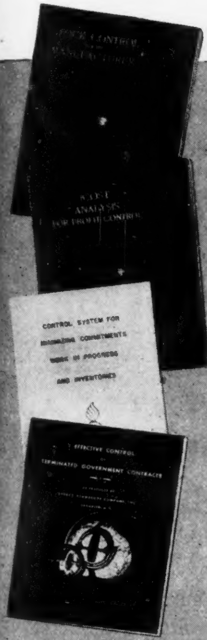

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